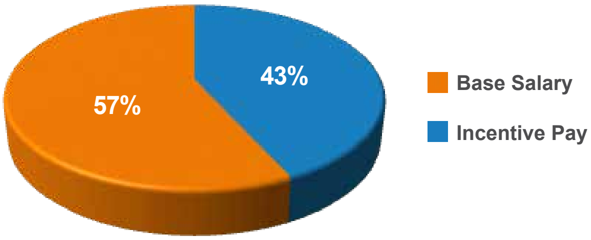
Aligning Pay With Performance in Endowment Incentive Plans

Incentive compensation plans in endowment investment offices[1] are designed to fulfill a number of important objectives—the most significant of which is to ensure the alignment of pay with investment staff performance. As investment returns are published and closely evaluated by stakeholders, the media and other constituents, it is essential for boards and management to establish an appropriate correlation between pay and performance and to ensure that the design of the incentive program is both successful and defensible. Endowments should regularly assess the programs in place to determine whether incentive pay and investment performance properly align with the organization's objectives, appropriately reflect the changing marketplace, and successfully deliver both competitive and reasonable compensation to investment staff.

Understanding Market Practices

While the prevalence of incentive compensation arrangements in endowment investment offices has steadied over the past decade, it remains high. In the *Endowment and Foundation Investment Staff Compensation Survey,* SullivanCotter conducts an annual assessment of key investment staff positions among leading colleges and universities, private foundations and other not-for-profit organizations. The 2015 report found that 98% of organizations with assets under management of greater than $1 billion offer incentive compensation to investment staff. For the Chief Investment Officer (CIO), incentive pay represents an average of 43% of total cash compensation.



98%

of organizations with assets under management of greater than $1 billion offer incentive compensation to investment staff.

[1] The term "endowment investment office" for the purpose of this article is defined as the investment team or group managing the endowment of a university, foundation or other not-for-profit organization.

SullivanCotter
AND ASSOCIATES, INC.

Other key findings from the survey indicate that incentive compensation is largely based on investment performance relative to the organization's policy portfolio benchmark, with 88% of organizations having reported this. On average, this represents 71% of the overall incentive award for the CIO. Measurement is typically done on a relative basis because it gauges the performance of actively managed funds that are expected to see a return greater than that of the market. Endowment investment staff seek to outperform the market, whether that means higher returns in a bull market or fewer losses in a bear market.

Absolute return measures, such as measuring the total portfolio return without regard to any external benchmarks, are only used in 21% of incentive plans and represent a minority weighting in determining the total incentive award. Absolute return alone does little to explain other key factors that influence how well an endowment performs: where the funds are currently invested, the board-mandated risk profile, and the investment policy and objectives of the endowment as a whole.

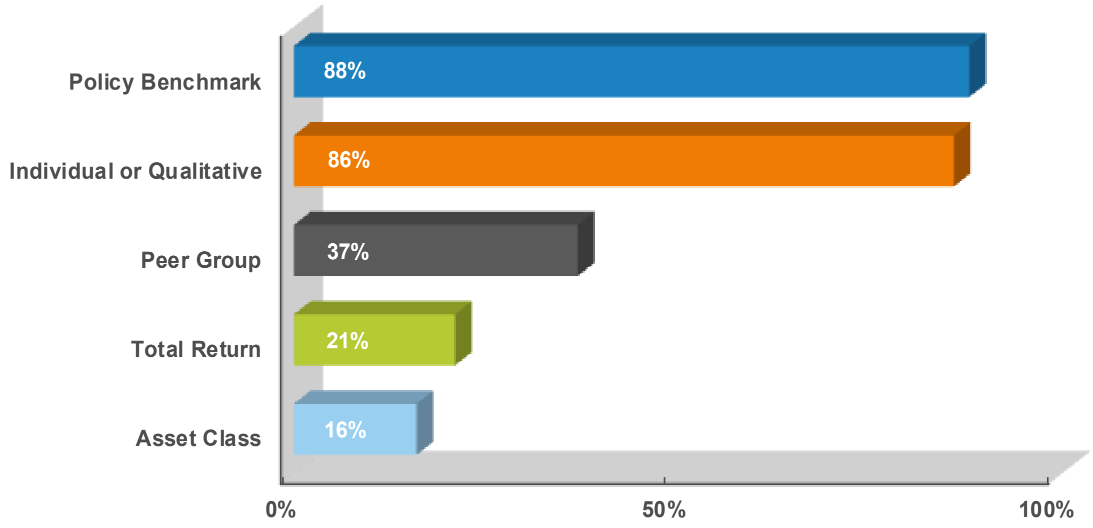
Peer group measures, where an organization's returns are compared to a group of specific peer organizations, have fallen out of favor over the last decade and continue to decrease in prevalence. On average, 37% of organizations currently have a peer group measure in place, and this is often weighted no more than 25% of the overall award. Although this approach provides a secondary metric to evaluate investment performance, it too evaluates absolute performance without consideration of the endowment's specific investment policy portfolio benchmark and objectives.

A comparison of published investment returns to a CIO's total cash compensation is not a good indication of whether or not an organization is rewarding for performance. For example, one organization may report lower published investment returns because its policy objective is to maintain stable growth in the portfolio, yet its funds are significant in value and managed by a seasoned and high performing CIO. In the case of negative investment returns, CIOs may earn performance-based incentive awards even when the overall endowment fund does not yield positive returns as a result of market conditions. In this circumstance, the CIO may be rewarded for decisions to help preserve capital, protecting the endowment from greater loss. Additionally, 48% of investment offices required some percentage of the incentive award to be deferred. The amount truly earned in a given performance period cannot be discerned from publicly available documents, as payout amounts reported may reflect partial earnings from the current year as well as awards that had previously been deferred.

Assessing Plan Effectiveness

By regularly assessing your endowment's incentive compensation plan, your organization can ensure that investment staff pay is properly aligned with performance. The following best practices are key assessment factors to consider in the incentive compensation decision-making process:

Prevalence of Endowment Incentive Plan Performance Measures



n=43
Note: Percentages will not add up to 100% due to the ability of respondents to choose more than one measure.

- **Consistency with the compensation philosophy.** Review the plan design in light of the organization's compensation philosophy of how competitive to be and with whom. For example, if the organization intends to compensate staff at the median of the market with target levels of performance, a review of the plan design and current compensation levels will indicate whether the existing program is aligned with the stated philosophy.

- **Appropriate peer group definition.** The peer organizations against which compensation levels and pay practices are compared is critical. Recent scrutiny by the IRS and other regulators has been focused on peer group composition, and aspirational peer groups (those that represent a desired future state, such as endowments with significantly larger assets under management) are difficult to defend. It is important to ensure that peers reflect the organization's current size, portfolio strategy and complexity, and not what the organization expects or hopes to look like in 10 years.

- **Alignment with investment objectives.** The metrics used and the period of time over which performance is measured should reflect the organization's investment objectives. For this reason, less than 10% of organizations measure performance over a one-year period. Most plans (82%) measure performance over a three-year period to balance a longer term time horizon with the reality of line-of-sight, investment staff tenure and the ease with which new hires can be incorporated into the plan.

- **Mitigation of risk.** How awards are interpolated (or not), capped and set relative to one another are important considerations for the mitigation of risk. For example, placing too much pay at risk can place a significant amount of pressure on the participants to deliver expected outcomes. This pressure may consciously or unconsciously affect decision-making.

- **Effective investment performance measures.** An effective incentive plan will have measures that staff can directly affect, such as performance relative to the policy benchmark. Incorporation of metrics over which investment staff may not have control or influence, such as absolute return or peer group measures, may lead to unintended behavioral consequences and affect the competitiveness of the plan.

- **Evaluation of performance in multiple contexts.** Incorporating the measurement and reward of individual contributions or the ability to qualitatively evaluate performance on both the overall organizational and individual level is an effective way to ensure that performance is evaluated and rewarded in multiple contexts. These contributions may include the successful leadership of staff in a particularly challenging economic environment, completion of an asset allocation study, or major rebalancing effort. This can provide a reference to not only what gets done but also to how.

- **The use of credible benchmarking data.** Quantitative plans based predominantly on investment metrics with a capped incentive opportunity have a greater chance of passing the test for reasonableness. Utilizing credible survey data is key in knowing where to set these caps. Custom peer groups can be helpful, but should represent a robust and appropriately broad sampling of the relevant talent market. In addition, multiple survey sources should be utilized whenever possible.

Process is Important

Aligning pay with performance for endowment investment staff and ensuring that the correlation is defensible requires a process of due diligence through board and management oversight and good governance of the compensation decision-making process. A regular assessment of incentive programs as well as a strong partnership between the Investment and/or compensation committee, management, and a qualified independent consultant is critical to the overall success and reasonableness of incentive compensation design.

CONTACT US

WWW.SULLIVANCOTTER.COM

888.739.7039